
Tricks and Traps for Trusts Holding Pass-Through Entities and Grantor Trust Issues

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Overview

- Changes by 2017 Tax Reform
- Dangers when those bequeathed the business interest are different than the owner's or primary beneficiary's residual beneficiaries
- Trap when trust or estate is in one state and the entity's assets are in another state

Overview

- Correcting apparently blown opportunities to get a basis step-up in a partnership's assets
- Beware basis step-down in a partnership's assets

Overview

- Creating business entities to generate superior fiduciary income tax results
- Mandatory income trusts holding partnership interests - results that may surprise some people
- Planning for the 3.8% tax on net investment income

Overview

- How an irrevocable grantor trust can surprisingly lose its automatic qualification to hold S stock
- Election deadlines for trusts owning S corporations

Changes by 2017 Tax Reform

- 2018 top bracket starts at \$12,500
- Top rate is 37%
- Code § 199A qualified business income deduction (II.E.1.c.)
- ESBT deduction for charitable contribution from S corporation's K-1 uses the Code § 170 limits instead of Code § 642 (III.A.3.e.ii.(b).)
- ESBT can include nonresident alien (III.A.3.e.ii.(a).)

Bequests With Different Beneficiaries

- Cash mismatch during transitional period (III.A.3.d.)
- QSST issues (III.A.3.d, III.A.3.e.i.(b))

Cash Mismatch

- Flow-through entity distributes enough to pay owners' quarterly estimates
- Sometimes distributes additional amounts either during or after year
- Often has large distribution to pay taxes with return: April 2017 distribution to pay 2016 taxes

Possible Cash Mismatch

- Distributions are payable to owners of record
- A dies January 31, 2018. Who receives 2017 tax distributions payable early April 2018?
- If partnership interest owned by A or A's revocable trust and the distribution is made during post-mortem estate/trust administration, then the person who received the distribution can use it to pay the 2017 tax

Possible Cash Mismatch

- What about 2018 income? The person receiving the 2017 tax distribution in 2018 will pay tax on 2018 income because of receiving a distribution in 2018. One needs to plan for a 2018 tax distribution with respect to the 2017 tax distribution.

Cash Mismatch - Irrevocable Grantor Trust and Second Marriage

- A has children, B and C, from marriage to now-deceased spouse, W.
- A sets up irrevocable grantor trust for B and C.
- A marries XXX, then dies after a honeymoon descriptive of XXX's name.
- A dies January 31, 2018.
- A leaves residue of A's estate to XXX.
- B and C receive tax distribution for 2017 paid April 2018. A's estate pays tax on 2017 income. Poor XXX!

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11



Cash Mismatch - QSST (III.A.3.d, III.A.3.e.i.(b))

- Same characters: A, B, C, and XXX.
- A's deceased spouse leaves QTIP trust for A, with B and C as remaindermen.
- A makes a QSST election.
- Same situation as before: A's estate pays tax on 2017 income, but B and C receive the tax distribution in 2018 as remaindermen of QTIP trust.

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12



Solution at Business Entity Level

- Make tax distributions payable to owner of record when related income was earned
- Consider not only 2017 tax distributions in 2018 but also possible audit of prior years' returns
- Will April 2018 owners consent, or should an owners' agreement already in place require this result?

Possible Corporate Law Impediment to Solution

- Corporate law (in some states) might limit retroactivity. For example, a dividend cannot be paid using a "record date" more than 70 days before date of distribution.
- Consider making dividend of a promissory note with a face amount provided by a formula referring to tax and related interest and any penalties with respect to any year before ownership change (including tax on note, which might carry out DNI).
- Consider converting entity to one not subject to that limitation.

Possible Estate Planning Solution (III.A.3.d, III.A.3.e.i.(b))

- Build into trust not created by decedent provisions for distributions to pay tax incurred by decedent or decedent's estate.
- Beneficiary exercises power of appointment to take into account this issue.
- Beneficiary negotiates tax reimbursement provision when making QSST election (II.A.2.i.ii. discusses IRS approval of temporary timing differences and II.A.2.i.iii. discusses disproportionate distributions).

Possible Estate Planning Solution (III.A.3.d.)

Sample language in trust:

If any partnership interest or stock in any S corporation is specifically allocated to one or more persons, the person(s) entitled to the allocation shall also be entitled to any distributions from the date of the allocation until the date the partnership interest or stock is distributed; however, any distributions that were intended for the payment of tax imposed on taxable items with respect to periods before the event that caused that allocation shall be paid to the person reporting those items.

Trusts Crossing State Lines

- Various rules govern residence of trust
- A trust or estate is taxed on business income earned in a state, whether or not the trust or estate is a resident of the state
- This rule applies whether the business income is earned directly or through a partnership or S corporation

Trusts Crossing State Lines

- The ownership interest itself, whether stock or a partnership interest, is situated in the state in which the trust or estate resides
- The difference between the state taxation of K-1 income and the taxation of disposition can generate unexpected results when an S corporation sells its assets then liquidates (II.H.8.a.i.)

Trusts Crossing State Lines - Example

- A holds 100% of S corporation, with zero basis
- S corporation holds land with zero basis and \$1 million value
- A dies, stepping up basis in stock to \$1 million but not changing the land's basis

Trusts Crossing State Lines - Example

- Corporation sells land for \$1 million
- A's estate reports \$1 million gain on K-1 from S corporation
- Basis in A's stock increases to \$2 million (\$1 million new basis at death plus \$1 million K-1 income)

Trusts Crossing State Lines - Example

- Corporation liquidates, distributing \$1 million cash to A's estate
- A's estate has \$1 million loss on liquidation (\$1 million proceeds minus \$2 million basis)
- For federal income tax purposes, \$1 million capital loss on liquidation offsets \$1 million capital gain on K-1

Trusts Crossing State Lines - Example

- Suppose estate is in Missouri, and land is in Illinois
- Gain on sale is Illinois income
- Loss on liquidation is Missouri loss
- Missouri allows offset, because estate is resident
- Illinois does not allow offset, because estate is nonresident

Trusts Crossing State Lines

- Same result occurs if estate sells S corporation stock and makes a Code § 338(h)(10) (or 336(e)) election to treat stock sale as asset sale followed by liquidation
- Same result occurs if estate holds partnership interest and a Code § 754 election was not made before the land was sold

Basis Step-Up for Partnership's Assets (II.Q.8.e.iii.(c).)

- Code § 743 provides new basis upon partner's death or sale or exchange of a partnership interest if a Code § 754 election is in place
- If a Code § 754 election is in place, deadline is partnership return for the year in which the death or the sale or exchange occurred
- What if miss deadline?

Basis Step-Up for Partnership's Assets

- Liquidate partnership
- Private letter ruling
- Sale or exchange of partnership interest

Basis Step-Up for Partnership's Assets

“Sale or exchange” includes nontaxable transfers (II.Q.8.e.iii.(b). and Reg. § 1.755-1(b)(5)):

- Contribute to new partnership
- Contribute to corporation
- Distribute as part of trust funding (II.Q.8.e.i.)

No need to worry about technical termination, which 2017 tax reform repealed.

Basis Step-Down for Partnership Assets (II.Q.8.e.iii.(c).)

- Unrealized inside loss of more than \$250,000 generates basis adjustment on partner's death or sale or exchange of partnership interest, even if a Code §754 election is not in place
- Selling enough loss assets to avoid a substantial built-in loss would generate current deduction and avoid basis step-down

Using Business Entities to Save Fiduciary Income Tax

- Partnership facilitating distribution of capital gains
- QSSTs as grantor trusts
- ESBTs to trap income
- Strategic Fiduciary Income Tax Planning (II.J.3.) and Tips for Fiduciary Income Tax Preparers (II.J.4.) are included for your study later

Partnership Facilitating Capital Gain Distributions

- Converting capital gain to fiduciary accounting income
- Using partnership interest to make noncash distributions

Capital Gain as Distributable Net Income (DNI) (II.J.8.)

Capital gains not DNI unless:

- Code § 1231 gain (II.J.8.a.i.),
- Actual or deemed distribution (II.J.8.c.ii. and iii.), or
- Included in fiduciary accounting income (II.J.8.c.i.).

Sale of Depreciable Property

- Not a capital asset (II.J.8.a.i.)
- Included in DNI but allocated to principal
- Depreciation recapture can be taxed at higher capital gain rates (real property) or as ordinary income (personal property)
- Code § 1231 loss recapture taxed as ordinary income

Actual or Deemed Distribution of Capital Gain (II.J.8.c.ii. and iii.)

List of exceptions – discussion follows:

- Refer to capital gain
- Trace distribution to capital gain
- Consistent allocation of capital gain to distribution of corpus (annual budgeted distribution)

Including Capital Gain in Annual Budgeted Distributions (II.J.8.c.ii.)

- The distribution is done without referring to capital gain
- Assumes no tracing of capital gain to distribution
- Irrevocable election first time distribute corpus when possible to allocate capital gain to beneficiary and not deemed or actually distributed under II.J.8.c.iii.

Fairness

- It's fair to tax a beneficiary who receives cash
- If the tax frustrates the distribution's purpose, distribute enough to pay the tax (and tax on this supplemental distribution)
- Better to pay taxes at the beneficiary's rate than at the trust's rate

Including Capital Gain in Annual Budgeted Distributions (II.J.8.c.ii.)

- What if stuck with no capital gain included in DNI and want to change that?
- Form a partnership
- All distributions that are not complete or partial liquidations constitute trust accounting income (II.J.8.e.)
- May allocate all, part, or none of capital gain to DNI (II.J.8.c.i.)

Uncertainty When Partnership Distributes Less than K-1 Income (II.J.8.f.)

- Absent substantial economic effect, all distributions carry out pro rata each class of income included in DNI
- This might result in some ordinary income trapped inside the trust
- Query result of interaction between pro ration under II.J.8.f. and flexibility of II.J.8.c.i. if less than all trust accounting income is distributed

Distributing Partnership Interest (II.J.8.d.)

- Distribution is the lesser of basis or fair market value unless elect to recognize gain
- Beneficiary can't spend the partnership interest
- Consider effect on future distributions (controlled by trustee)

QSSTs as Grantor Trusts - Overview (III.A.3.e.vi.)

- Grantor Trust Treatment
- Sale to QSST
- Sale by QSST

QSST – Grantor Trust Treatment (III.A.3.e.i.(a))

- All K-1 income
- Mandatory income aspect – controllable
- Consider varying administrative fees 50% principal
- Sole beneficiary during life
- Recall prior discussion re: post-termination tax distributions

Sale to QSST (III.A.3.e.vi.(a).)

- S stock – no gain or loss
- Interest expense allocated to grantor trust portion
- Receivable → double paying

Sale by QSST (II.J.15.a.)

- Sale back to beneficiary – taxable
- Sale taxable to trust
- Depreciable assets – DNI allocated to principal (II.J.8.a.ii.)
- Possible catch-up distribution to income beneficiary? (II.J.8.c.i.(b)., II.J.12.)

Termination of QSST (III.A.3.e.vi.(b).)

- No tax-free split-up unless meet Code § 355 tests
- If using merely to create grantor trust for marketable securities, consider separate S corporations – one for each remainderman

ESBTs to Trap Income

- Beneficiary relative to tax bracket
- Toggling
- Flexible trust

ESBTs To Trap Income – Rates (III.A.3.e.ii.(c).)

- Beneficiary in top bracket – phase-outs
- Nonresident or low income tax trust;
beneficiary higher state tax bracket
- Divide trust to segregate reinvested
distributions

ESBTs to Trap Income – Toggling (III.A.3.e.iv.)

- No limit on first toggle
- Before toggle to QSST, split trust if other assets
- 36 month wait thereafter
- Sole beneficiary after QSST
- Inter vivos power to appoint is turned off permanently after QSST election

Mandatory Income Trusts – Partnership Interest (III.D.2.)

- Accounting income = deemed distribution
- K-1 income corresponds to DNI
- What if distributions vary from DNI?

Mandatory Income Trusts – Partnership Interest (III.D.2.)

- DNI = 100x
- Distribution = 40x
- Tax Rate = 40%

Mandatory Income Trusts – Partnership Interest (III.D.2.)

If distribute to beneficiary entire partnership
distribution:

- Taxable income approx. 60x (100x - 40x)
- Tax = 24x (60x x 40%)

Mandatory Income Trusts – Partnership Interest (III.D.2.)

If retain all of partnership distribution to pay tax:

- Taxable income approx. 100x
- Tax = 40x – fully paid by partnership distribution
- No distribution to beneficiary!

Mandatory Income Trusts – Partnership Interest

Compare to C corporation:

- All tax paid at corporate level
- No dividend
- Same result

Mandatory Income Trust – Partnership Interest (III.A.4.)

Solution:

- Entity needs to distribute more than enough to pay tax
- If no history of doing that, asking for trouble if relying on entity income
- Need agreement to distribute more or mechanism to sell trust's partnership interest

Mandatory Income Trust – Partnership Interest (III.A.4.c.iii.(c).)

Trust agreement should address:

- Any purpose beyond distributions to beneficiaries
- Waiver of prudent investor rule
- Duties of loyalty and impartiality
- If marital trust, right to make productive

Mandatory Income – Partnership Interest

Beware QTIP with buy-sell (II.O.2.c.)

- Buy-sell price \$1,000,000
- IRS determines FMV = \$1,000,001
- Disallow marital deduction completely

Planning for 3.8% Tax on Net Investment Income (NII) (II.I.8.)

- Passive vs. nonpassive income (II.8.a.)
- Investments (II.I.5.)
- Interest on working capital (II.I.8.a.v.)

3.8% NII Tax

- Nonrental income
- Rental income

3.8% NII Tax – Nonrental Income

Material participation ideal (II.K.1.a.ii.)

- More than 500 hours current year
- More than 500 hours 5/10 past years
- Professional service – any 3 years
- Other exceptions apply

3.8% NII Tax – Nonrental Income

Significant participation (II.I.8.a.i., II.K.1.h.)

- More than 100 hours
- Recharacterizes income but not loss
- Some credits disallowed due to mismatch (II.K.1.h.i.(b).)

3.8% NII Tax – Rental Income

Per se passive (II.I.8.c., II.K.1.e.), except:

- Real estate professional
- Self-rental plus more than 500 hours
- No significant participation exception (other than structure in II.E.5., II.E.6.)

3.8% NII Tax – Participation (II.K.1.a.)

- Includes spousal work
- Excludes investor work
- Make-work: excluded for loss but included for income

3.8% NII Tax – Participation by Nongrantor Trust (II.K.2.a.)

“An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating.”

- IRS treats as exclusive test
- *Mattie Carter* did not accept IRS' view

3.8% NII Tax – Participation by Nongrantor Trust

- Audit manual - relaxed
- National office and litigation position - strict
- Impossible for traditional corporation per TAM 201317010

3.8% NII Tax – Participation by Nongrantor Trust

Way to comply (II.K.2.b.ii.)

- Authorize shareholders to manage, bypassing board
- Management contract to trust
- Trustee fee; Form 1099-MISC

3.8% Tax – Participation by Grantor Trust

- Look to deemed owner's participation
- No IRS roadblocks
- QSST or regular grantor trust

3.8% Tax – Grantor Trust

Plan for nongrantor trust:

- QSST sale of stock, business assets, etc.
- Turning off grantor trust powers

Need trustee to participate while grantor trust?

State of Guidance on Trust Participation

- Comments (II.K.2.b.i)
- Timeframe for guidance
- Approach until guidance

Irrevocable Grantor Trust - Beware Separation (III.A.3.a.ii.)

- Irrevocable trust deemed owned by grantor includes spouse as a beneficiary
- Spouses separate so that Code §682 applies
- Trust is no longer a wholly-owned grantor trust if deemed owned by the grantor generally but distributions are made to the beneficiary spouse

Irrevocable Grantor Trust - Beware Separation

- Trust needs to have an ESBT election in place no later than 2 months and 15 days after separation (III.A.3.c.)
- Consider ESBT election up front; grantor trust trumps Code § 641(c); disadvantage of ESBT election is less favorable taxation 2 years after grantor's death if trust is grantor trust at death (the latter III.A.3.b.ii.)

Election Deadlines for Trusts Owning S Stock (III.A.3.c.)

- If deemed owner dies, two years after death (including QSSTs)
- However, if trust is a revocable trust taxed as an estate under a Code §645 election, it may hold the stock until the Code §645 election terminates
- Code §645 (II.J.7.) election expires 6 months after closing letter is issued if estate tax return is required; IRS decision not to issue closing letters is favorable
- Expires 2 years after death if smaller estate

Election Deadlines for Trusts Owning S Stock

- Compare trust income tax to tax rate of beneficiary of successor trust (if QSST election is available)
- Fast funding of successor trust might be desirable, but consider tax reimbursement issue we discussed earlier and whether administrative expenses need to be deducted (especially for estates not subject to estate tax due to asset size or marital deduction)

Election Deadlines for Trusts Owning S Stock

- Trust created under a will may hold stock until second anniversary of trust's funding
- This applies to trusts created under a revocable trust with a Code § 645 election in place
- If qualifies as a QSST, might not want to wait

Election Deadlines for Trusts Owning S Stock

- Can draft QSST so that successor is automatically QSST (III.A.3.e.i.(b))
- If remaindermen not those the beneficiary wants to benefit, tax reimbursement issues might trump convenience

Sample Language

If the individuals to whom the S corporation stock is allocated do not share in the residue of the deceased beneficiary's estate [refer to Article allocating residue to provide example of what "residue" means], then any distributions the S corporation makes to pay its shareholders' taxes with respect to their distributive shares of taxable income before the date of death shall be treated as income earned before the beneficiary's death and paid to the beneficiary's estate.

If and to the extent the above does not apply, during trust administration, after the beneficiary's death and before separate trusts can be funded, the trust will not terminate but rather will continue as a single trust with separate shares pursuant to U.S. Treas. Reg. section 1.1361-1(j)(9)(ii), Example (1), and the trusts for the beneficiaries will be amended under [the QSST provisions].

Election Deadlines for Trusts Owning S Stock (III.A.3.c.iii.)

- Nongrantor trusts have 2 months and 15 days to get ESBT or QSST election in place
- Rev. Proc. 2013-30 grants inadvertent termination relief within 3 years and 75 days
- Consider protections in buy-sell agreements

Grantor Trust Issues (III.B.2.)

- The regulations under Code § 671 describe the portions to which the grantor trust rules apply and rules governing taxpayer IDs
- Code § 672 provides important definitions
- Code §§ 673, 674, 675, 676, and 679 determine when these rules may apply
- Code § 678 treats a beneficiary as an owner

Regulations under Code § 671

- Portions are corpus/principal or income
- Whoever is true settlor is treated as the grantor in testing under the grantor trust rules
- General power of appointment does not shift grantor unless exercised (Reg. § 1.671-2(e)(5))
- Reg. § 1.671-4(b) describes reporting

Beware Termination by Death (III.B.2.e.ii.)

- New tax ID required if trust continues.
Reg. §§ 1.671-4(h)(2), 301.6109-1(a)(3)(i)
- Because the trust income tax return from after the date of death until December 31 will not be a taxable year of 12 months, the trust cannot use the prior year exception for calculating payments of estimated income tax. Code § 6654(d)(1)(B) (last sentence).

Code § 672(a) “Adverse Party”

- “A substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust”
- Beneficiary may be an adverse party only as to part of the income or principal, depending on the beneficial interest.

Code § 672(a) “Adverse Party”

- If A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A’s consent, the grantor is treated as the owner of three-fourths of the trust. Reg. § 1.672(a)-1(b).
- A beneficiary with only a mandatory income interest is not adverse as to principal passing at his or her death. Reg. § 1.672(a)-1(c).

Code § 672(a) “Adverse Party”

- A remainderman’s interest is adverse to the exercise of any power over the trust’s corpus, but not to the exercise of a power over any income interest preceding the remainder. Reg. § 1.672(a)-1(d).
- Although I feel unsafe relying on being adverse, some incomplete gift non-grantor trust (ING) rulings are favorable.

Code § 672(c) “Related/Subordinate Party”

- Spouse if living with the grantor.
- “The grantor’s father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.”

Code § 672(e) Spousal Attribution

- Any individual who was the spouse of the grantor at the time of the creation of such power or interest
- For above, legally separated under a decree of divorce or of separate maintenance not considered as married
- Any individual who became the spouse of the grantor after the creation of such power or interest

Code § 682 Legal Separation or Divorce

- Distribution to legally separated or divorced spouse taxable to distributee rather than grantor
- Only to the extent of actual distributions
- Overrides grantor trust rules
- Possibly bust S election if based on wholly owned grantor trust (III.A.3.a.)

Code § 674(a) Distribution Authority

Grantor treated as owner of a portion in respect of which:

- Beneficial enjoyment of corpus or income
- Subject to a power of disposition
- Exercisable by the grantor or a nonadverse party, or both
- Without the approval or consent of any adverse party

Beneficial Enjoyment of Income

- Ascertainable standard exception applies only if solely exercisable by the trustee(s), none of whom is the grantor or spouse living with the grantor. Code § 674(d).
- Accumulated income payable to beneficiary, estate, or appointees under broadest possible nongeneral power of appointment. Code § 674(b)(6)(A). N/A if add to class except after-born or adopted.

Beneficial Enjoyment of Income

- Income payable on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument. Code § 674(b)(6)(B). N/A if add to class except after-born or adopted.

Beneficial Enjoyment of Corpus

- Ascertainable standard. Code § 674(b)(5)(A).
- Distribution of corpus chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if separate share. Code § 674(b)(5)(B).
- Both N/A if add to class except after-born or adopted.

Independent Trustee – Corpus or Income

- Solely exercisable by trustee(s), none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the grantor's wishes. Code § 674(c).
- N/A if add to class except after-born or adopted.

Code § 675(2)

- Power exercisable by the grantor or a nonadverse party, or both
- Enables the grantor to borrow the corpus or income, directly or indirectly
- ~~Without adequate interest or~~ without adequate security
- Except where general lending power to make loans to any person without regard to interest or security.

Code § 675(3)

- Grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year.
- Exception for certain loans by independent trustee subservient to the grantor.
- Basis for Rev. Rul. 85-13.

Code § 675(4)(C)

- Power to reacquire corpus by substituting other property of an equivalent value.
- Held by any party, if exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.
- Latter is based on facts and circumstances. Reg. § 1.675-1(b)(4)(iii).

Code § 675(4)(C)

- Sample clause in part III.B.2.h.ii. Swap Power
- Include release of power
- Include agent's authority
- Prefer to refer to Rev. Rul. 2008-22 (and Rev. Rul. 2011-28, if applicable)

Income Tax Reimbursement (III.B.2.j.iv.)

- Rev. Rul. 2004-64
- Need to use law of DAPT state
- 10-Year lookback under Bankruptcy Abuse and Prevention Act of 2005
- Later adding reimbursement clause – Letter Ruling 201647001 viewed reimbursement clause as “administrative in nature” and not a “beneficial interest”

Conclusion

- When drafting a nongrantor trust, look carefully at the grantor trust rules to avoid their inadvertent application
- When drafting a grantor trust, be sure that one can turn off grantor trust powers, if possible (Code § 677 may make impossible)
- When dealing with multistate business, beware that not all states follow federal

Conclusion

- Email me at sgorin@thompsoncoburn.com for full searchable PDF of my business structuring materials (over 1,500 pages).
- Free quarterly newsletter includes the most recent version of the PDF. Completing form at <http://www.thompsoncoburn.com/forms/gorin-newsletter> gets you the PDF and newsletter.
- Blog that is less technical is at <http://www.thompsoncoburn.com/insights/blogs/business-succession-solutions>.